ECBC
European Covered Bond Council
The Covered Bond Voice of the European Mortgage Federation

European Covered Bond Council's Position Paper on Asset Encumbrance and Response to the European Banking Authority Consultation Paper on Asset Encumbrance Reporting

Brussels, 24 June 2013

The European Covered Bond Council (ECBC)[1] represents the covered bond industry, bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. The ECBC was created by the European Mortgage Federation (EMF) in 2004 to represent and promote the interests of covered bond market participants at international level. As of June 2013, the ECBC brings together over 100 members from more than 25 active covered bond jurisdictions. ECBC members represent over 95% of the €2.67 trillion outstanding covered bonds.

Executive Summary

The recent increase in asset encumbrance in a number of countries has raised questions about the underlying driving forces and consequences for financial stability. Thus, the issue of asset encumbrance has become a major topic of debate in capital markets over recent years. Asset encumbrance - and the subordination implications it would have for senior unsecured creditors - has been seen as a cause for concern and attention quickly turned to the role of covered bonds when, in 2011, their issuance in the EUR market exceeded the issuance of senior unsecured bonds for the first time. In this context, the ECBC believes it is crucial to clarify the industry position and views.

To this end, the ECBC welcomes the opportunities recently given by European regulators to hold a comprehensive debate in this respect and, in particular, welcomes the following initiatives:

- Recommendations of the Financial Stability Board (FSB) recommendations, 29 October 2012 (Recommendation 19, page 11) - here
- Recommendations of the European Systemic Risk Board (ERSB), 20 December 2012 - here
- European Banking Authority (EBA) Consultation Paper on Asset Encumbrance Reporting, 26 March 2013 - here

The ECBC completely agrees on the crucial importance of guaranteeing a proper balance between secured and unsecured debt and of lowering any potential excessive encumbrance. We strongly believe that the asset encumbrance issue needs to be addressed through a holistic and gradual approach taking into consideration all different sources of encumbrance.

Asset encumbrance indeed varies over time and across banks and countries. This variation can be justified by the level of financial distress, demand and supply dynamics of safe assets and differences in countries' financial systems and banks' business models. Notably, a large part of encumbrance is hard to measure and this may lead to focusing mainly on the most visible and transparent part of encumbrance, such as covered bonds, and hence reaching biased conclusions. Therefore, the ECBC deems necessary to emphasise, in its response to the EBA Consultation Paper, the following points:

[1] The European Covered Bond Council is registered in the European Institutions' Transparency Register under European Mortgage Federation ID Number 24967486965-09.

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- In the first place, we would like to stress the key role that the covered bond asset class plays in guaranteeing the financial stability. Especially during the recent financial turmoil, covered bonds have been one of the only asset classes able to restore investor confidence and to ensure to European issuers access to debt capital markets.

- As acknowledged by the recent European Commission Green Paper on Long-Term financing, the intermediation process by which the supply of funding is channelled towards investment has been under pressure over recent years. This is especially the case for commercial banks – the traditional financial intermediaries in Europe (over 75% of total intermediation). For over 200 years, covered bonds have proved to be an efficient debt instrument enabling banks to mobilise private sector means and capital towards long term investment with a wide public benefit and, in particular, housing loans and public sector debt.

- The ECBC considers that asset encumbrance should not be reduced to a simple encumbered assets to total assets ratio. In our view, the issue should be addressed through a holistic approach and, thus, we invite European regulators to take into account the following points:

  - The different covered bond models are characterized by the existence of risk cushions foreseen in their specific legal frameworks (strict supervision, eligibility criteria for high quality cover assets, etc.). Covered bond legislation acts, in practice, as an additional mitigant and issuance safeguard by requiring licenses for covered bond issuance and imposing strict collateral asset eligibility criteria.

  - It is challenging to define what the ideal encumbrance equilibrium should be. Recent studies prove that there does not exist any evidence of correlation between the covered bond encumbrance of a bank and its senior unsecured spread levels.

  - In particular, the existence of different business models implies in our views a case by case interpretation of the level of asset encumbrance. For specialised issuers for instance, the level of encumbrance – given a broad definition – is close to 100%. For those financial institutions which do not take any deposits, all senior investors are institutional investors who are well aware of their position in the priority ranking in case of insolvency. For such institutions, the high level of encumbrance is only a consequence of their business model and cannot be interpreted differently.

  - Due to the restrictive cover pool eligibility criteria, covered bond encumbrance tends to remain more stable and less sensitive to market conditions in times of turmoil than other forms of encumbrance arising from Repo haircuts or derivative collateral.

  - The covered bond market has experienced a smooth development over recent years with an average growth of 7.5% since 2007. Compared with the other forms of encumbrance (central bank repo transactions and derivative collateral), and considering the recent introduction of covered bond laws in a number of countries which did not have legislation on covered bonds in place, this remains a sustainable development. This growth has often been misinterpreted because, in parallel, the senior unsecured and securitisation issuance has been shrinking.

- Last but not least, the ECBC believes that establishing hard limits on covered bond issuance would be a short-term and one-size-fits-all solution. These limits would be detrimental for this essential asset class and, therefore, for the European banking industry as a whole. We, therefore, invite European regulators to further investigate other potential solutions and we would like, in particular, to draw their attention to the recent initiative launched by the industry – the Covered Bond Label initiative – which aims to improve information disclosure and transparency in this market.

This paper is divided into two sections: the first section provides general comments regarding covered bond and asset encumbrance; the second section (page 18) responds to specific questions on covered bonds raised in the European Banking Authority's consultation Paper on Asset Encumbrance Reporting.

Section I: General Remarks on Covered Bonds and Asset Encumbrance

1. Covered Bonds and Financial Stability

Covered bonds are one of the key components of European capital markets with the asset class playing an important role as a robust long term financing instrument contributing to the efficient allocation of capital and, ultimately, economic development and prosperity.

Under the prevailing adverse market conditions, covered bonds have proved to be the most reliable wholesale funding source, significantly contributing to overall financial stability. It is important to note in that context that the act of encumbering assets itself does not increase the probability of default. On the contrary, the encumbrance of assets tends to increase banks' cash holdings and thus decrease banks' immediate probability of default.

In fact, from an issuer's perspective, covered bonds provide a significant contribution to the enhancement of a banks' funding profile and the management of liquidity. Benefits provided by covered bonds include:

1) extending the maturity profile of the liabilities, allowing banks to better match their long-term asset portfolios;
2) providing stability to the funding mix, allowing Asset Liability Management (ALM) teams to increase predictability in the maturity profiles;
3) enabling issuers to increase diversification in the investor base, both in terms of geography and investor type;
4) Securing loan assets which are otherwise illiquid assets (e.g. mortgage loans), and thereby improving the liquidity of bank balance sheets; and
5) serving the industry as one of the most reliable funding tools, even in times of turmoil.

In the context of financial stability, covered asset encumbrance also actively contributes to restore investors' confidence in the European banking system. Therefore, asset encumbrance does not necessarily represent a constraint for senior unsecured creditors and the additional subordination it creates can, to a certain extent, be offset by the benefits that this brings to viability of European banks.

From an investor's perspective, the major strengths and regulatory advantages of covered bonds can be summarised as follows:

1) double recourse to issuer and cover pool;
2) higher rating and higher rating stability than unsecured debt;
3) lower-risk weighting for EEA Covered Bonds bought by EEA banks;
4) favourable treatment under Solvency II;
5) generally better liquidity through larger issue size;
6) favourable repo treatment at the European Central Bank (ECB) and other central banks;
7) eligible as liquid assets under upcoming Basel III rules; and
8) no risk of bailing-in

In addition, the fact that issuers of covered bonds keep the credit risk of cover bond collateral on their balance sheets ("skin-in-the-game") has been clearly identified, from a macro-prudential perspective, as

an efficient and simple alternative to complex originate-to-distribute products and, therefore, as a key driver for a virtuous cycle in managing risks and ensuring financial stability.

This explains the success of covered bonds which, for two and a half centuries and through many crises, have played an increasingly important role in the financing of real estate, public sector and ship assets. With over EUR 2.67 trillion outstanding at the end of 2011, covered bonds continue, now more than ever, to play a central role in banks' funding strategies. The EUR 695 billion issuance and arrival of 30 new issuers during 2011 for a total of more than 300 issuers in more than 25 Member States evidence the ability of the asset class to provide essential access to long term capital market funding, even during volatile market conditions, notably thanks to a stable investor base.

We are thus seeing new issuers enter the market and new covered bond frameworks being established in many countries around the world. Moreover, covered bonds' consistently strong performance and quality features have attracted the attention of regulators and market participants worldwide, which, in turn, has led to an increasing recognition of the macro-prudential value of the asset class.

2. A long term funding tool for the real economy: the example of housing finance

The covered bond industry shares key objectives and challenges of the current legislative developments undertaken in Europe, which aim at contributing to the long term growth of the European economy by designing a robust and efficient private financial sector able to ensure financial stability and long term financing.

Covered bonds are indeed an effective tool to channel long term financing for high quality assets at reasonable cost. They improve banks' ability to borrow and lend at long term horizons and, hence, represent a stable source of funding for key banking function such as housing loans and public infrastructure. In this regard, we believe that covered bonds represent a key funding tool for the future European banking industry.

For instance, long-term financing is crucial for housing finance. Building or purchasing a home is the most major investment for the majority of European citizens, representing typically 4 to 5 times their annual income. In absence of pre-existing wealth, they would have to wait for 40 or 50 years if they had to rely solely on their individual savings.

Borrowing resources are therefore necessary to acquire a home and more generally to support the European economy. Given the size of the investment, their repayment must be spread out over a long period to be compatible with annual savings capacity and, hence, requires long term funding tools for banks to avoid asset and liabilities mismatches. Covered bonds are typically designed for mortgage lending, and it is important to recall that a mortgage-focused bank thus tends to have more asset encumbrance than a bank with a non-mortgage focus. Cutting back lending capacities of those more specialised mortgage-focused banks would limit the credit supply the economically so important area of housing finance.

The efficient availability of mortgage finance is also based on the ready availability of financing at the longest tenors possible and the lowest price feasible. Without this, the mortgage market would be a

function of market sentiment and the refinancing rates available to borrowers would be subject to much more price volatility, making planning for private households more challenging.

In this context and in particular in times of low risk appetite from investors, covered bonds with their key safety features such as strict legal and supervisory framework, asset segregation, a cover pool actively managed in order to maintain the quality of the collateral, play an essential role in ensuring the flow of capital in financing long term growth and the real economy.

During recent turmoil, the existence of a well-functioning covered bond market has allowed governments in Europe to constantly channel private sector funds to housing markets and maintain a relatively efficient lending activity without additional increase of the burden for taxpayers and public debts. This is the case for instance in the US, where 95% of the mortgage markets benefit from a governmental guarantee after the federal takeover of Fannie Mae and Freddie Mac.

3. Covered Bonds and Asset Encumbrance

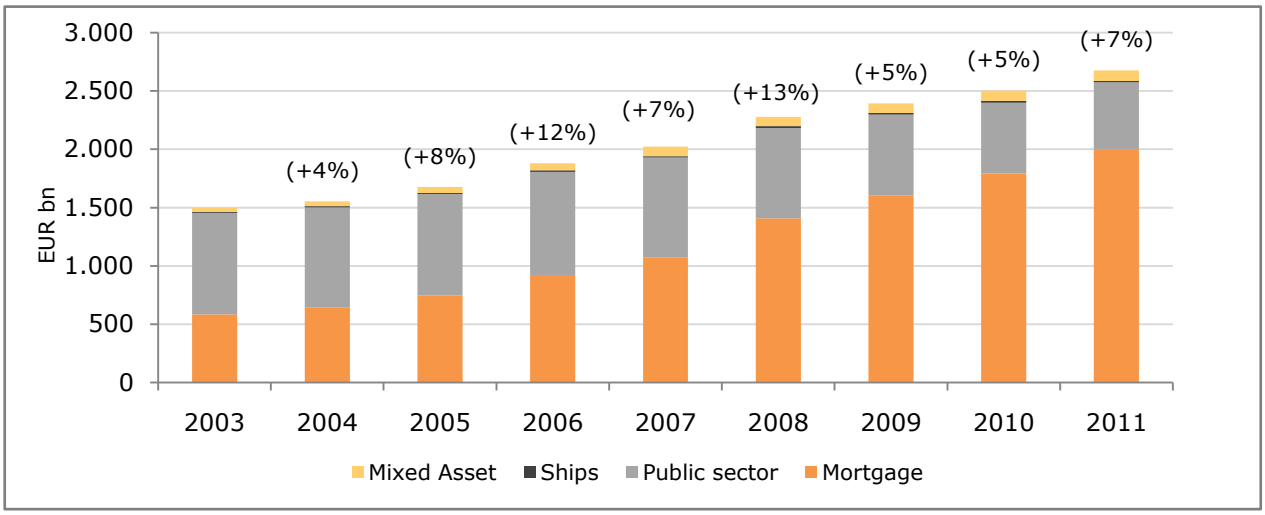
3.1 Growing Covered Bond Issuance

- **Covered bond market developments**

Interestingly, whilst the covered bond market has experienced a smooth development over the last 10 years in absolute value with an average growth of 7.5% per year for the total covered bonds outstanding, the volume of assets pledged in Eurosystem operations increased annually by 15% on average. Moreover, the covered bond growth was fuelled by the increase in the number of issuers and covered bond legislation worldwide. For instance, according to European Covered Bond Council (ECBC) statistics, the number of covered bond issuers increased from 233 in 2007 to 319 in 2011, and the average outstanding volume per issuer actually fell from EUR. 8.7bn equiv to EUR. 8.4bn equiv. Furthermore, since 2006, many countries have passed new covered bond laws reinforcing the legal framework of the asset class, and hence, attracting new investors and favouring the increase of the total outstanding. This concerned for example Australia (2011), Belgium (2012), Canada (2007), Cyprus (2011), France (2010), Greece (2008), Italy (2008), Netherland (2005), New Zealand (2010), Norway (2007), Portugal (2006), Sweden (2006) and the United Kingdom (2008). This shows that funding diversification and mobilisation of previously unused collateral pools plays a key role as a motivation to use covered bonds and, consequently, increases the total outstanding.

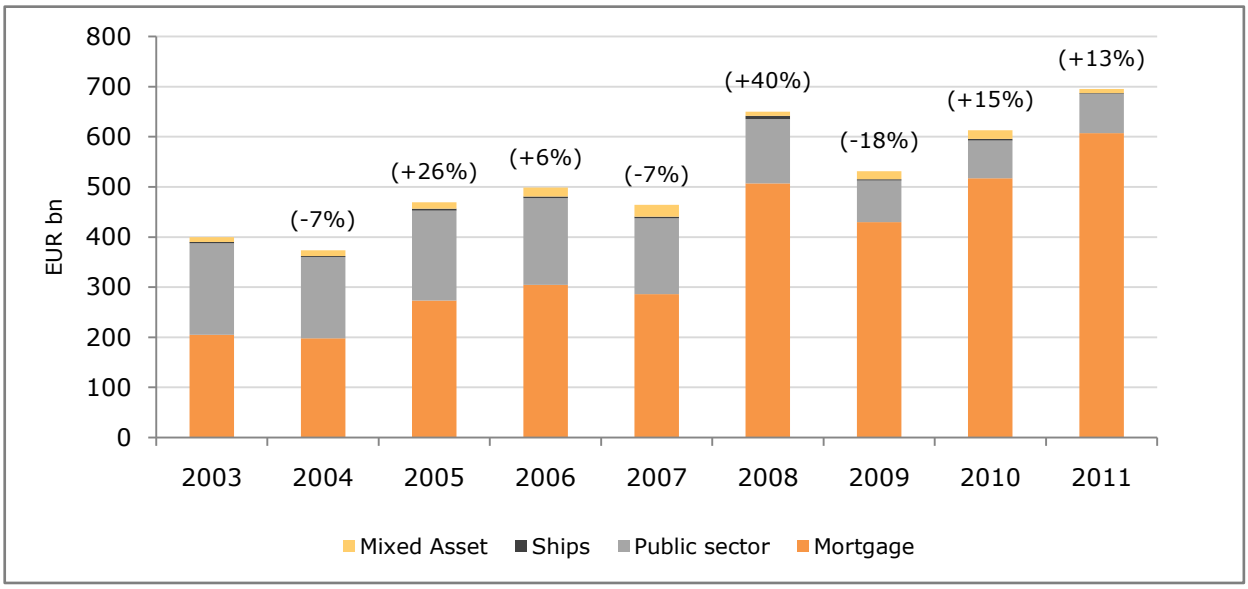
Moreover, covered bond supply exceeding senior unsecured supply has proved to be the exception rather than the rule when, in 2012 and 2013, like prior to 2011, senior unsecured issuance again clearly outpaced covered bond issuance

- Covered Bond worldwide outstanding 2003 - 2011



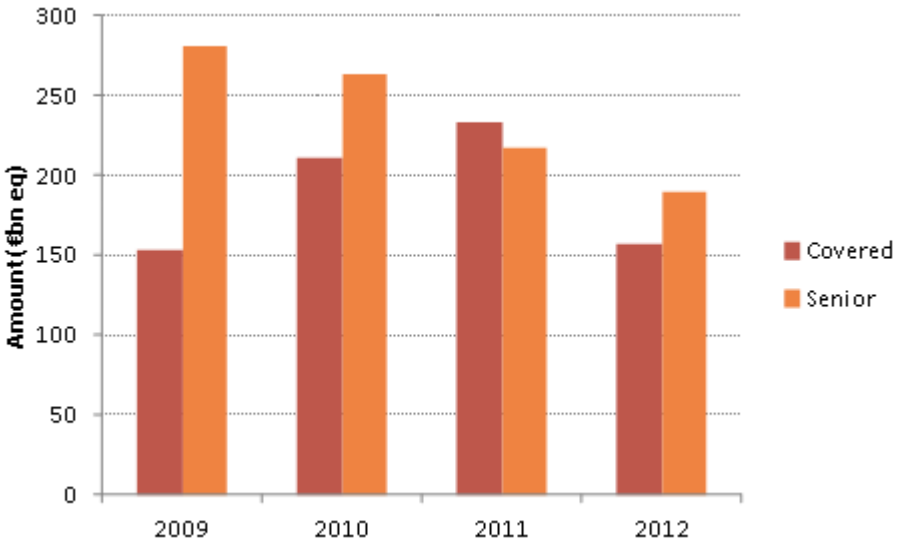
Source: ECBC

- Covered Bond worldwide issuance 2003 - 2011

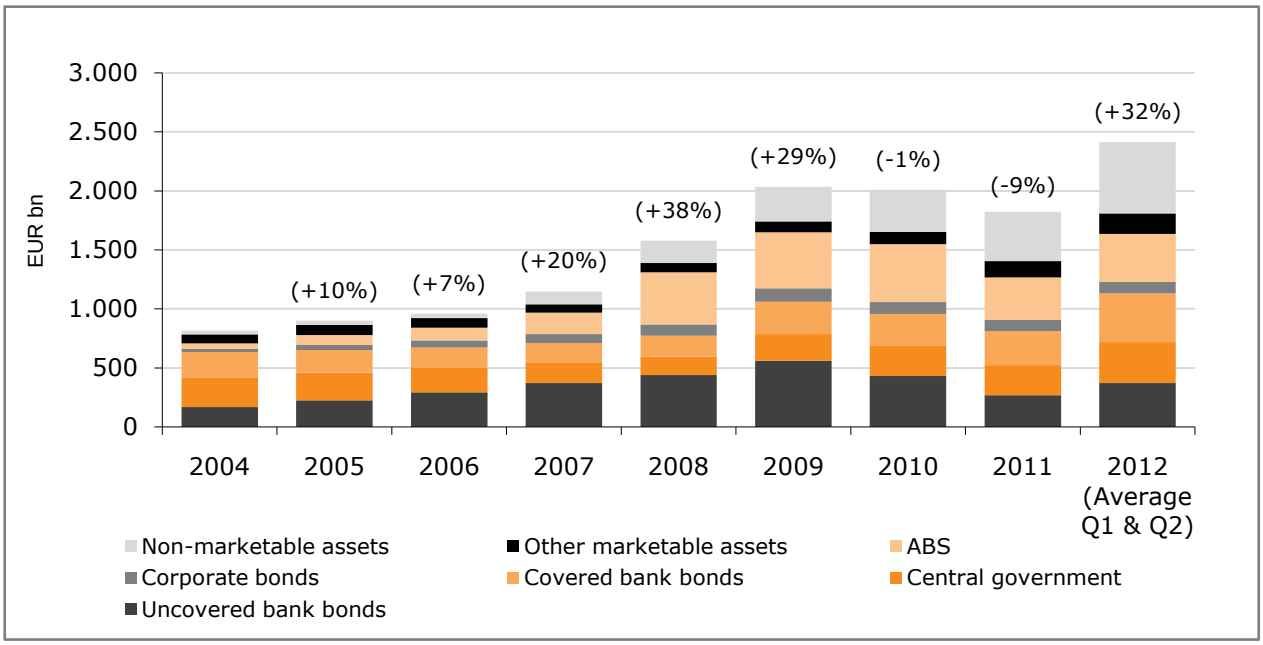


Source: ECBC

- Covered Bond and Senior Unsecured Supply Volumes



- Use of collateral by asset type in Eurosystem operations (EUR billions, after valuation and haircuts)



Source: European Central Bank, ECBC

However, it is true that over recent years, the relative share of covered bonds in percentage terms has tended to increase in European banks' funding mix (though year-to-date, senior unsecured issuance by European banks has been almost double the size of this year's covered bond supply). The development of the covered bond market has also benefited from the combined effect of four main factors:

- Shrinking of senior unsecured issuance;
- Shrinking of securitisation issuance;
- Investors flight to quality; and,
- Deleveraging of European banks balance sheets.

Recently, covered bonds have been one of the few asset classes able to bridge the gap between issuers and investors. This global trend has therefore reinforced the dependence of financial institutions to this funding channel and has increased the amount of covered bonds on their balance sheets.

- **The right encumbrance equilibrium**

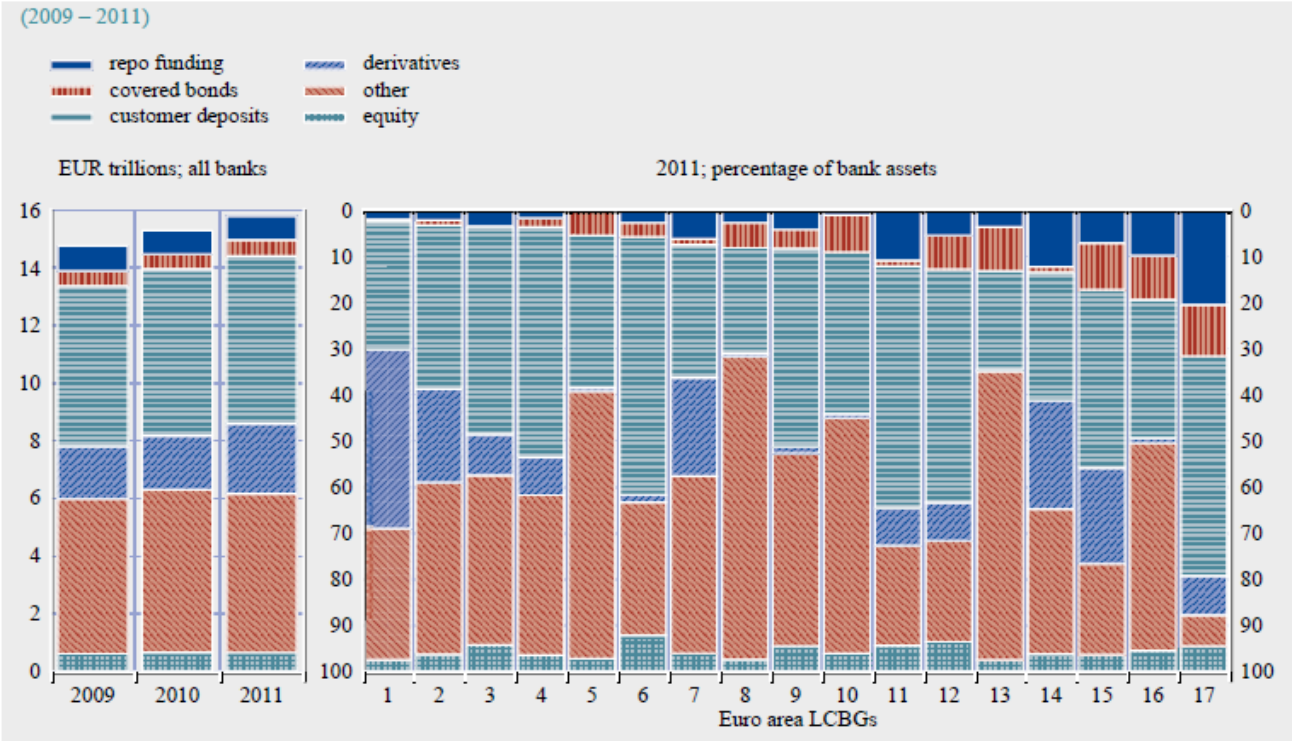
When we look at asset encumbrance it is important to note that the level of asset encumbrance varies over time and across banks and countries. This should be analysed by taking into consideration the funding structure of the issuer, i.e. looking at bank funding sources, market funding and capital; and also by acknowledging the reasons why changes may take place, e.g. increases in asset encumbrance can arise from the need to restore investor confidence and financial stability.

We believe that it is crucial to analyse all sources of asset encumbrance: short term secured funding, such as repos; long term secured funding, such as covered bonds; but also other sources of encumbrance such as derivates and insurance claims. Against this background, it is worthwhile stressing that, in some jurisdictions, covered bond issuers are specialised issuers with no deposit funding and, hence, in these cases any asset encumbrance caps or limits adopted would simply not be relevant.

Regulators already have a broad set of instruments available to counterbalance and to identify the optimal level of encumbrance by adopting a case by case approach. In this respect, an important contribution is given by the Covered Bond Label, which provides a framework for more harmonised and transparent disclosure of data on the asset side of the covered bond issuers. We believe that deviating from this targeted approach and setting any hard limits across the board can seriously hamper the capabilities of an issuer to react in times of distress, thereby reducing importantly the set of actions that a bank may choose from in case of market turmoil.

The level of encumbrance of European bank assets is very heterogeneous and it is very difficult to find a clear geographical trend in this area. According to the European Central Bank, "*looking at euro area Large and Complex Banking Groups (LCBGs), the share of secured funding in total liabilities (approximated by the combined share of covered bonds and repo funding) varied within a wide range of between 2% and 32% at the end of 2011, suggesting a significant heterogeneity in asset encumbrance levels among banks, which in turn reflected differences in their business models or specificities of their local funding markets.*"

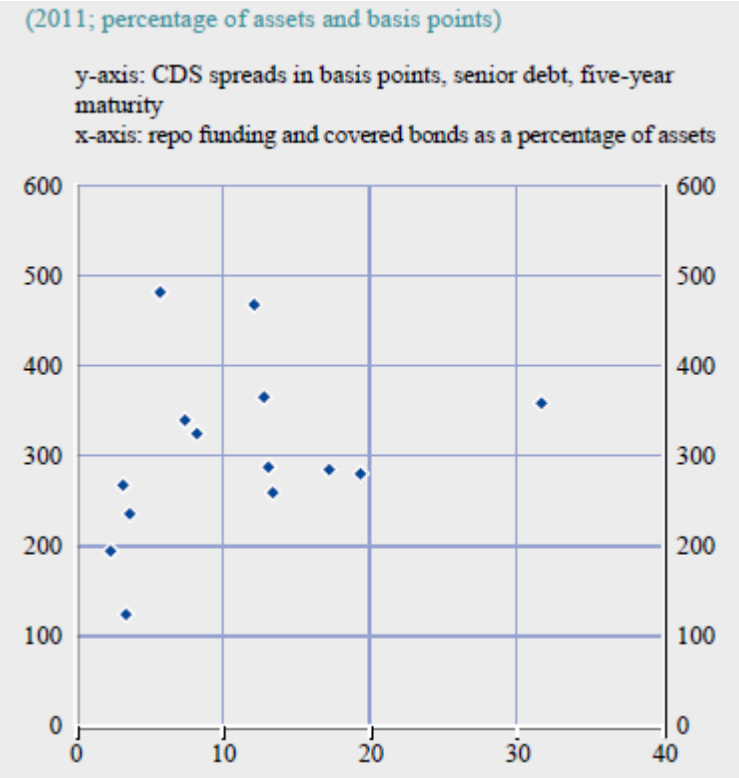
- Liabilities of selected liabilities euro area LCBGs from 2009 to 2011



Source: Bank reports and ECB calculations.
Notes: Data cover 17 euro area LCBGs. Repo funding includes both central bank and private sector repos.

Although at first glance, the risk of structural subordination for unsecured creditors and depositors increases with the level of pledged assets, asset encumbrance does not always seem to be a good indicator of banking stress. Higher asset encumbrance levels should normally imply lower recovery rates on senior unsecured debt and, consequently, unsecured debt investors may start to demand higher compensation for assumed risks. However, there does not seem to exist any evidence of correlation between the covered bond encumbrance of a bank and its senior unsecured spread levels. The ECB indicates in this regard that, "*a cross-sectional regression analysis of five-year bank credit default swap (CDS) spreads on the share of secured funding in overall funding (calculated as the sum of repo and covered bond funding in total assets or in total assets excluding derivatives) and the corresponding sovereign credit default swap (CDS) spreads revealed that only the sovereign factor was a statistically significant driver of bank CDS spreads in 2011, and also in 2010".*

- Asset encumbrance and bank CDS spreads



Sources: Bank reports, Bloomberg, Dealogic and ECB calculations.
Notes: Data cover 14 euro area LCBGs for which CDS spread data was available. Repo funding includes both central bank and private repos.

This proves that asset encumbrance is a complex issue that needs to be addressed through a holistic and gradual approach. Notably, the different covered bond models (e.g. specialised issuers), the legal framework regulating the product, the existence of risk cushions or the total amount of unencumbered assets on the balance sheet have to be carefully considered. Covered bond legislation also acts in practice as an additional mitigant and issuance safeguard by requiring licenses for covered bond issuance and imposing strict collateral asset eligibility criteria.

In a recent study, Bank of America Merrill Lynch identified four types of encumbrance which show the heterogeneity among credit institutions and the difficulty to define the right equilibrium in this regard. They categorise asset encumbrance as follows:

1. High but safe;
2. A response to the crisis;
3. Beyond covered bonds;
4. Diluted by international operations.

- **Covered bond transparency**

Discussions on asset encumbrance have not really acknowledged the positive impact on financial stability but rather created the myth that the growing issuance of covered bonds would boost asset encumbrance and, therefore, rather destabilise the system. This belief was fostered by the high visibility of covered bond issuance and the transparency of underlying cover pools, while other and more important sources of asset encumbrance (e.g. repo, collateral for derivatives) expanded more in secrecy. Over recent years, the covered bond community has made significant efforts to improve the transparency of their asset class promoting in particular the following initiatives:

- ECBC statistics on worldwide covered bonds outstanding and issuance have been published since 2004 (here);
- ECBC Fact Book (here);
- ECBC Comparative database providing description of the legislative framework of every covered bond model and the official legislative text in English (here)
- Covered Bond Label (here) providing both covered bond data at issuance level in a comparable format and cover pool data displayed (on each individual issuer's profile from January 2013) on the basis of the respective National Transparency Template

Whilst we recognise the concern linked to the increased level of asset encumbrance in recent years due to the need of ensuring investors' confidence in the private sector by using intensively secured funding, when issuing covered bonds this increased level of encumbered assets appears to be manageable as it is strictly supervised and investors have enough information to exercise due diligence. Therefore, we do not consider it appropriate to highlight covered bonds as the main source of asset encumbrance since, in comparison to other sources of encumbrance, they present a high level of transparency and they are under the direct control of the supervisory authorities.

3.2 Quality Limits Better than Quantity Limits

- **Covered bond over-collateralisation**

Another popular myth in the asset encumbrance debate is the view that the downswing in the credit cycle would force covered bond issuers to boost over-collateralisation (OC) in their covered bond programmes, thereby encumbering more assets without generating new funding.

Eligibility criteria for cover pool assets play an important role in that context. Restricting cover pool eligibility to high-quality collateral, as covered bond frameworks do, has the advantage of effectively limiting the issuance capacity of covered bonds and consequently asset encumbrance. Moreover, restricting cover pool eligibility leads to higher resilience of covered bonds in credit cycle downswings. Consequently, increases in OC requirements due to deteriorating cover pool quality are unlikely, and therefore, covered bond encumbrance would tend to remain more stable and less sensitive to market conditions in times of turmoil than other forms of encumbrance arising from Repo haircuts and derivative collateral. These assets turn to have a higher contingent encumbrance than covered bonds and embed pro-cyclical triggers that require more collateral when a bank's credit and/or market conditions deteriorate. They are both more vastly and more heavily correlated to the bank's health than the mark to market of mortgages. Therefore, the share that covered bonds represent within the total encumbrance of European banks would tend to decrease in a stress scenario.

This is confirmed by recent studies from Moody's and S&P which indicate that throughout the financial crisis, collateral quality deterioration only played a subordinated role as a reason for requests to increase OC. Asset-liability related (e.g. refinancing conditions) or issuer/sponsor related reasons (e.g. sovereign or systemic risks) are far more important when it comes to defining OC requirements. For example, S&P stated that "on average, about two-thirds of OC levels relate to the coverage of ALMM risk." (S&P, 24th of January 2013: Covered Bonds Face Another Tough Year). A comparison of Moody's collateral risk indicators for mortgage covered bond programmes from 2009 and 2012 shows decreases or maximal small increases for most jurisdictions (source: Moody's European Covered Bonds Monitoring Overview).

Of note is the fact that most covered bond downgrades could not have been prevented through boosting OC. As Fitch notes in its December 2012 Covered Bond Surveillance Snapshot, only 13% of the 61 covered bond downgrades in 2012 were caused by lack of OC. Consequently, instead of increasing OC levels, which could not prevent downgrades of their covered bonds, a significant number of issuers kept OC levels unchanged. The *de facto* increases of OC seen in numerous covered bond programmes were rather motivated by precautionary reasons, i.e. to have collateral available to generate liquidity in case the crisis resurges. However, as unsecured funding markets stabilise, most issuers will decrease OC and return to a more credit-quality oriented OC management.

Lastly, it is worth noting that an increasing proportion of covered bonds now use extendible maturity structures which both reduce the amount of over-collateralisation needed (as refinancing risk is lower) and reduce the probability of a fire-sale of assets which both crystallises a loss for unsecured creditors and, presumably, is likely to exacerbate a stress scenario.

To sum up, ensuring that covered bond legal frameworks set high-quality standards for cover assets increases the security of the product and limits the issuance capacity but leaves enough flexibility to allow covered bonds to contribute to financial stability. Evidently, this is a more promising strategy than simply imposing quantity limits for covered bond issuance.

- **Hard limit on covered bond issuance?**

Over these years of crisis, taking into account the concerns raised about covered bonds as a source of asset encumbrance, some countries with new covered bond laws are limiting the volume of covered bonds in order to protect creditors of unsecured funding (please see below). This aims to improve acceptance of the new laws by creditors of unsecured claims and so that an overly sharp increase in encumbrance is limited from the outset.

- Limits on covered bond issuance per country

Country	Limit on covered bond issuance
Australia	8% of total Australian assets
Belgium	Maximum amount is capped at 8% of issuer total assets
Canada	4% of total assets
Greece	20% of total unencumbered assets
Italy	Issuance limited to a percentage of eligible cover assets. Limits are based on capitalisation of the institution however (no limit if tier 1 >11% + tier 2 > 7%)
Netherlands	Ratio between covered bonds to total assets has to be "healthy", DNB decides on a case by case basis
New Zealand	10% issuance limit on the proportion of a New Zealand bank's assets that may be encumbered in favour of covered bonds
US	According to the FDIC's Covered Bond Policy Statement and the US Treasury's Best Practice Guide: 4% of total liabilities

The ECBC believes that the establishment of a global hard issuance limit for covered bonds would be very detrimental for this market in particular and for the banking industry in general. We consider that such a limit would create additional instability within the European banking sector and additional refinancing difficulties for banks in times of financial turmoil. For instance, what would happen if a bank had already reached its issuance limit but can only access the funding market through covered bonds? The banks would also lose operational options, particularly for refinancing shortfalls and rating downgrades. The use of covered bonds offers a comprehensive set of funding options which allows issuers to have a significant margin of manoeuvre in stress scenarios. Moreover, regulators should be aware that in many cases banks would not want to fully use up the available limit for covered bond issuance as they most likely would prefer to have some issuance headroom left for rainy days when other funding channels are closed.

More specifically, from our perspective, an absolute limitation seems also particularly critical, as they would endanger existing stable business models especially in traditional covered bond markets. The definition of a common ratio appears very challenging at European level due to the different models that are currently in place. Even within EU Member States, different banking models impede the establishment of such a hard limit. In particular, an issuance limit would not make any sense for a specialised issuer without deposits and senior unsecured creditors. In addition, countries which have established a legislative issuance limit (Australia, Canada, Singapore, Belgium etc.) have no specialised banks and are relatively new covered bond markets with outstanding covered bond volumes per issuer still very low. There are long-established covered bond markets in several countries including Denmark, France, Germany and Sweden. In these jurisdictions, dedicated covered bond banks often exist that do not take in retail deposits and that provide a key service to the economy, but which would be catastrophically impacted by any absolute encumbrance limit.

Therefore, we consider that an issuance soft cap established on a case-by-case basis might be more relevant in this area, especially as this could be easily implemented thanks to the licence systems already in place in several jurisdictions. Such system is already in place in the Netherlands. The breach of a soft cap should result in an increase in incremental capital required rather than a strict ban to issue new covered bonds.

3.3 More Transparency Would Help

- **Which ratio to disclose?**

Since asset encumbrance has become such a mythical issue, more transparency would clearly help a return to reality and discussions over the past two years have identified several indicators or measures for asset encumbrance. Evidently, depending on the issuer's business model, one indicator could present a more appropriate picture than the other. However, from the point of view of the senior unsecured bondholder, it is most important to know which assets cover his claim in case of default, so the most appropriate indicator is the ratio of unencumbered assets to unsecured liabilities. It is not actually the commonly cited **share of encumbered assets to total assets** that matters to unsecured creditors of banks, but rather the **ratio of unencumbered assets to unsecured liabilities** (which is more directly relevant to unsecured creditors worried about getting paid back in the event of default).

In particular for specialised institutions, as is the case for many covered bond issuers, the ratio of unencumbered assets to unsecured liabilities provides a fairer picture than the pure encumbrance ratio (encumbered assets/total assets), which is usually very high for such issuers. Instead, their lower dependence on unsecured funding corresponds to a high ratio of unencumbered assets to unsecured liabilities, indicating a comfortable level of protection for senior unsecured bondholders.

Of course, total capital ratio is another indicator for the level of senior bondholder protection as encumbrance only kicks in when the capital is absorbed. Moreover, the incentives for high underwriting standards, which go along with using covered bonds as main funding instruments, are also beneficial for the expected recovery ratio of senior unsecured bond holders. With their 2012 results, issuers have started to publish information on asset encumbrance, but we are far from any form of standardisation however.

When comparing the different sources of asset encumbrance, one should keep in mind that encumbrance induced by covered bonds is a long term, non-volatile, good quality form of encumbrance justified by banks' business models. Other sources of asset encumbrance could exhibit much faster, more volatile swings in their volumes as the hurdles to mobilise assets are lower than in covered bond frameworks where usually, a cover pool monitor needs to approve asset transfers. In addition, covered bonds enjoy high disclosure standards for outstanding volumes and cover pool composition. It is desirable that similar high standards are also applied to the more important sources of asset encumbrance, i.e. central bank and third party repo and credit support annexes of derivative transactions.

- **The Covered Bond Label, improving further transparency and information disclosure**

A straightforward way to increase market discipline and lower excessive encumbrance is enhancing transparency. Over these years we have seen a clear commitment to enhance transparency in the covered bond market through the establishment of the Covered Bond Label. This initiative undertaken by the issuer community was based on an intense and constructive dialogue of the investor community, major national and European authorities, as well as with the main law firms active in the covered bond arena who have supported and followed the creation of the Covered Bond Label Foundation and its website.

The Covered Bond Label and its Transparency Platform (www.coverdbondlabel.com) have been fully operational since January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. This transparency tool provides very detailed asset and liability side information and facilitates the investors' due diligence when comparing different issuer models, products in different markets and national supervision.

In fact, covered bond issuers from these 14 different jurisdictions have come together to develop a National Transparency Template providing cover pool information in a harmonised format on the basis of common guidelines agreed at European level. This chosen format allows for both the recognition of national and business model specificities and the comparability of information required to facilitate investors' due diligence.

As of early April 2013, a total of 79 labels have been granted to 65 issuers from 14 European Member States for a total face value of covered bonds registered amounting to over €1.4 trillion (approximately 53% of the total covered bonds outstanding).

4. Conclusions

Covered bonds represent a very important and stable funding tool for banks. They play a crucial role in the financing of both the European housing market and the public sector, particularly on the sub-sovereign level. The alternative (to ensure the same provision, tenor and cost of mortgages that are currently available within the European Union) would be a far greater level of state support for mortgage finance in line with the support that the United States is now obliged to provide to Fannie Mae and Freddie Mac to ensure a working mortgage market.

The ECBC welcomes the plans from European regulators to improve the disclosure of the level of asset encumbrance of European banks as not all forms of asset encumbrance are subject to the same very high standard of disclosure requirements of covered bonds. However, the ECBC strongly argues against the introduction of limits on covered bond issuance. The market already views encumbrance as a complex matrix that is not absolute, but a function of the business model, asset quality, capital structure, funding mix, geographical scope and track record of covered bonds. Therefore the asset encumbrance calculations also need to be seen in this light, as part of a mix of evaluations and monitoring measures of bank solvency and liquidity, but not in isolation. The available data also suggests that covered bond encumbrance is not the majority of the balance sheet encumbrance for a great many banks and that, indeed, derivative and repo financing may be a far greater proportion. Any ratio should be done on an individual bank level and in such a manner that recognises that the funding and asset structures of banks are heterogeneous and that one size would not fit all.

Since asset encumbrance has become such a mythical issue, more transparency would clearly help a return to reality and discussions over the past two years have identified several indicators or measures for asset encumbrance. Evidently, depending on the issuer's business model, one indicator could present a more appropriate picture than the other. However, from the point of view of the senior unsecured bondholder, it is most important to know which assets cover his claim in case of default. So, it is not actually the commonly cited **share of encumbered assets to total assets** that matters to unsecured

creditors of banks, but rather the **ratio of unencumbered assets to unsecured liabilities** (which is more directly relevant to unsecured creditors worried about getting paid back in the event of default).

The ECBC believes that a straightforward way to increase market discipline and lower excessive encumbrance is enhancing transparency. Over the last few years we have seen a clear commitment to enhance transparency in the covered bond market through the establishment of the Covered Bond Label. This initiative undertaken by the issuer community was based on an intense and constructive dialogue of the investor community, major national and European authorities, as well as with the main law firms active in the covered bond arena who have supported and followed the creation of the Covered Bond Label Foundation and its website.

The Covered Bond Label and its Transparency Platform (www.coverdbondlabel.com) have been fully operational since January 2013, providing detailed covered bond market data, comparable cover pool information and legislative details on the various national legal frameworks designed to protect bondholders. This transparency tool provides very detailed asset and liability side information facilitating the investors' due diligence when comparing different issuer models, products in different markets and national supervision.

Section II: ECBC Response to EBA's Consultation Paper on Asset Encumbrance Reporting

General Comments

The complexity of collecting the requested asset encumbrance (AE) figures must be balanced against the added value for supervisors of receiving the targeted information vs. only slightly less calibrated figures. The complexity of the data collection exercise for banks is further increased through cover pool reporting requirements stipulated by national covered bond legislation. These national requirements, together with the already existing reporting requirements for LCR and/or NSFR, should be taken into account and consistency amongst all of them should be strived for. Indeed, the information requested in all these Templates is similar, although not identical, and further consistency would be welcome.

Many templates require the allocation of encumbered assets to "matching liabilities". For example, the Template AE-Adv specifies that encumbered assets/encumbered collateral received shall be listed against matching liabilities. The template AE-Maturity requires the allocation of encumbered assets to the corresponding residual maturity of liabilities as well as the templates AE-Assets and AE-Collateral, where debt securities and loans on demand must be divided into "encumbered" and "unencumbered" and valued at FV and CA. However, in most European covered bond regimes, the allocation of an individual encumbered asset to a specific matching liability is not possible, as the cover pool in whole serves as collateral for all outstanding covered bonds. As matching of assets and liabilities generally takes place at cover pool level, the requested figures can only be collected at cover pool rather than at single asset and liability level. Should the templates indeed be completed with figures collected at cover pool level, we would very much appreciate confirmation from EBA in that respect.

Whilst we recognise the advantage of using accounting values in order to reconcile the reported figures with the balance sheet items (FINREP), we believe that further guidance in the instructions (Annex II) would be necessary. The validation rules appear incomplete in this respect (it refers to AE-Assets and AE-Sources only) and this produces particular challenges for smaller institutions applying local GAAP only and not reporting under FINREP.

In our view, the proportionality principle should also be respected throughout all templates. We have noticed that this is not the case in the template D on "covered bonds". Please note that this is further developed below. Furthermore, the proportionality principle should also apply to the reporting frequency. As such, we wonder whether the quarterly frequency for the templates A, B and D is the appropriate one. Changes of or within cover pools are not material enough over a 3 month period to justify a quarterly reporting requirement. Instead, a semi-annual reporting would seem to be a more adequate time interval.

Finally, given the high level of complexity of the templates, the development of new IT-processes will be necessary and, thus, we would recommend postponing the reporting framework from 1 January 2014 to 1 January 2015 in order to allow for the correct implementation of the IT changes.

1) Is the definition of asset encumbrance sufficiently clear?

We welcome that a wide definition has been proposed, based on economic principles and covering all assets that are subject to any restrictions in withdrawal. However, such a broad definition may only be relevant, if it is further specified that encumbrance can occur in different degrees with different

consequences, i.e. some assets may be encumbered in the right direction allowing them also to be used in other transactions depending on the situation. The systemic risk of asset encumbrance depends on the specific business models as mentioned in the ECBC Position Paper above, and indeed is not relevant for some specialized issuers with no deposit funding.

Additionally, some covered bonds are issued through an ad hoc and distinct entity, an SPV, which assets constitute the cover pool and covered bond holders benefit from a preferential claim on these assets. However, only cash-flows deriving from those assets are allocated in priority to the paiement of the interests and the redemption of the bonds and not the assets themselves. This preferential claim does not make the assets unavailable and they remain liquid, free to be sold and can be mobilized for central bank Repo as long as the overcollateralization level is compliant with the legal requirements. Therefore, on a consolidated basis, at the level of the issuer's parent company or at the belonging-group level, cover pool assets should be considered as "encumbered" at the level of the outstanding covered bond. In this case, encumbrance is not assessed at the level of the issuer only, and the assessment of the availability of assets makes sense in light of other financing sources (deposits, senior debt etc.). Failure to do so would create an incompatibility with LCR rules, as the distinct entity is typically a Credit Institution according to the CRR, and as such its LCR would be by definition equal to zero if all its assets were viewed as encumbered.

2) Do you agree with the decision to follow the level of application as set out for prudential requirements? If not, what other level of application would be appropriate?

Yes, it seems to be appropriate to incorporate the ITS into the full reporting framework, especially into the COREP reporting framework.

3) Do you believe the chosen definition of asset encumbrance ratio is appropriate? If not, would you prefer a measure that is based solely on on-balance sheet activities (collateral received and re-used, for instance from derivatives transactions would not be included) or a liability?

In order to be in line with the wide definition, it would be consistent to include off-balance sheet items into the calculation of the encumbrance ratio threshold. We therefore favour the second alternative of this Paper, focusing on the liabilities (secured liabilities divided by total liabilities). In our view, it is important to fully capture institutions with important off-balance sheet activities, because collateralised derivative transactions represent an increasing market segment and collateral is an important driver of asset encumbrance.

However, and as mentioned in the ECBC Position Paper above, given that from the point of view of the senior unsecured bondholder what is most important is to know which assets cover his claim in case of default, the most appropriate indicator in our view would be the **ratio of unencumbered assets to unsecured liabilities**. This ratio is more directly relevant for unsecured creditors worried about getting paid back in the event of default. Therefore, this would be our preferred option.

4) Do you agree with the thresholds of respectively 30 bn. € in total assets or material asset encumbrance as defined as 5% of on-and off-balance sheet assets encumbered? If not, why are the levels not appropriate and what would be an appropriate level? Should additional

proportionality criteria be introduced for the smallest institutions? Under what circumstances might unencumbered assets of the types of loans on demand, equity instruments, debt securities and loans and advances other than loans on demand not be available for encumbrance?

In our view, the reporting requirements should also be further calibrated on the basis of the proportionality principle, as we see the need to provide a certain level of reporting relief to those institutions with a small covered bond issuance activity.

We would therefore suggest introducing a 5% threshold for the specific reporting template for covered bond programs (Template Part D). Indeed, institutions should only be requested to report on covered bonds if their asset encumbrance level triggered by covered bonds is equal to or larger than 5%.

Below such a threshold, the encumbrance risk to institutions and to the financial system cannot be considered substantial and, hence, it would not justify the reporting burden. In these cases, asset encumbrance triggered by covered bonds is sufficiently covered through the reporting of Template Part A, which is to be delivered on a semi-annual basis.

We would also support the inclusion of another proportionality criteria for specialised issuers, i.e. financial institutions where the level of encumbrance – given a broad definition – is close to 100%. For those institutions which do not take any deposits, all senior investors are professional investors who are well aware of their position in the priority ranking in case of insolvency. Therefore, for such institutions, we consider that the reporting burden would also not be justified as such reporting would not help investors' due diligence or public supervision.

Finally, in the case of banking groups, where the funding is only processed through the mother company and group members are funded internally, the asset encumbrance reporting should be restricted at single institution level, thereby exempting the group level.

5) Under what circumstances might unencumbered assets of the types of loans on demand, equity instruments, debt securities and loans and advances other than loans on demand not be available for encumbrance?

Unencumbered assets might not be available for encumbrance in the following cases:

- Assets that are not central bank eligible and which are not recognised as a security by private markets;
- Debt securities which are blocked for minimum reserve purposes and/or intraday-liquidity management; or
- Syndicated loans where the borrower did not consent the right to assign or transfer the loan or parts of the loan.

6) What additional sources of material asset encumbrance beyond the one listed in rows 20 to 110 and 130 to 150 in template AE-Source do you see?

The template seems to correctly reflect all material asset encumbrance sources.

7) Do you believe the central bank repo eligibility criteria is an appropriate marketability criteria or should other criteria, such as risk weights, be used? If other criteria should be used, what could be the alternative?

There are good arguments in favour of the central bank eligibility criteria, as the crisis evidenced that repo-eligible assets were still marketable during stress scenarios. However, we very much advocate for a common approach across different reporting lines in order to streamline the reporting burden and realise synergy effects. Therefore we would suggest referring to Art. 404 (3) of the CRR when identifying the marketability of assets, in line with the criteria applied in the area of liquidity reporting. Along the same line, risk weights of assets would also be appropriate marketability criteria, as they are already available in the "data-warehouse" of credit institutions.

8) Do you believe the chosen scenarios are appropriately defined? What alternative definitions would you apply? Additional questions in Annex II

The application of a decrease by 30% of the fair value of encumbered assets is probably not realistic. We therefore question the value of the stress-scenario, particularly as stress-scenarios are already embedded in national legislation.

As matter of principle, the cover value calculation on the national level (net present value approach) already takes stress-scenarios into consideration. Should these national simulations be factored into the scenarios of Template C, the resulting figures would be based on scenarios which would be stressed twice. We would therefore welcome a dispensation from the inclusion of national stress simulations into the calculation of the stress-scenarios of Template C, should it be maintained.

9) Does the instructions provide a clear description of the reporting framework? If not, which parts should be clarified?

Most of our concerns arise within Templates D and C:

- Part 'D', Covered Bonds:

  We would like to refer to the footnote below Template AE-CB Issuance (Part D), where additional sets of rows 010 to 040 shall be added for each additional covered bond. We would suggest replacing the term "covered bond" by "cover pool".

  To take into account what is indicated in the answer 1 and 4, we would like to add a footnote in the reporting part D to remind that "in the case of covered bonds issued by a distinct specialized entity, the reporting must be filled in only at the level of the parent company on a consolidated basis".

  - Template AE-CB Issuance (5.2):

    Please refer to the ECBC Paper above for further feedback.

It is not clear whether this template also applies to "Registered Covered Bonds"', or only to "Bearer Covered Bonds".

We would recommend a merger of row 020 (present value – swap) with row 030 (asset-specific value). As the asset-specific value translates into a full fair value, it is unclear how this value would deviate from the market value of row 020. In such a case, we are of the opinion that the same figure should be introduced in both rows. Alternatively, we would welcome guidance on the delimitation of market value and fair value.

Regarding rows 220 to 250, we would like to emphasise that these figures can only be provided at cover pool level and not at a single covered bond level. Therefore, clarification in that respect would be much appreciated.

Finally, please note that covered bond funding does not constitute the only long-term encumbrance. The ECB's two longer-term refinancing operations with a maturity of 3 years and collateral for longer-term derivatives, especially as part of the initial margin, are just two other examples of long-term asset encumbrance. This should be taken into consideration when introducing reporting templates requiring information on covered bonds which are not required for the other asset encumbrance drivers.

- Template AE-CB Eligible Assets (5.3):

The reporting of unencumbered assets eligible for the cover pool represents a significant administrative burden. Covered bond issuers would have to apply the whole set of national eligibility criteria to all balance sheet items outside of the cover pool. This exercise would require the classification of all "remaining" balance sheet assets in terms of their potential eligibility features, the application of specific valuation rules to real estate assets and other covered bond specific criteria.

This administrative burden appears to be even more disproportionate in cases where the share of the cover pool in the balance sheet of the bank is not substantial. In our view, the costs generated by the Template do not justify the supervisory added value.

The term "unencumbered assets eligible for cover pool" would also cover debt securities. However, debt securities are not listed any more in the subsequent boxes.

We challenge the availability of an "asset-specific value" (IAS 39) of unencumbered assets. The reporting of the "carrying amount" varies in accordance to the accounting rules applied (national accounting rules vs. IFRS) and is not intrinsic to the cover pool management.

Finally, row 060 might not lead to a meaningful result. Cover pool derivatives and derivatives outside of the cover pool are concluded on the basis of different master agreements. It is legally not possible to transform an unencumbered derivative into an encumbered cover pool derivative as such a transaction has to be qualified as a "novation" requiring the termination of the existing unencumbered derivative contract. Hence, it is legally not possible to encumber a derivative which has been concluded outside of the cover pool.

- Part 'C', Template AE-Contingent:

  Please refer to our response to Question 8.

  In addition, some confusion arises from the wording of the instruction N° 26.A, "decrease by 30% of the fair value of encumbered assets", in comparison with the Instruction N° 28, "it shall be assumed that all encumbered assets decrease 30% in value". There is room for interpretation that a 30% decrease in value shall only be applied to assets which have been valued on the basis of fair value and not to assets valued at book value (e.g. loans). Therefore, further clarifications would be welcome in this respect.

  Finally, we would also welcome guidance on the treatment of hedge transactions within the stress-scenarios (derivatives inside and outside of cover pools), as ignoring these transactions would considerably distort the overall picture.

- Part 'A', Encumbrance Overview

  - Template AE-Collateral (2.2):

    It is unclear whether row 230 "other collateral received" also covers mortgage collaterals. Our understanding is that this is not the case. Otherwise, this reporting requirement would become particularly burdensome.

  - Template AE-Sources (2.4):

    We would welcome further guidance on the meaning of "% in market" of the requested carrying amounts (rows 090 to 110).

- Part 'E', Template AE-Adv1:

  We would welcome more detailed instructions on the figures required under the boxes "matching liabilities". Should the received securities be reported here, we would expect a position "matching assets".

  Another difficulty consists in the determination and reporting of the carrying amount of total unencumbered and/of which central bank eligible assets: we are unsure as to how this assessment (valuation of potential central bank eligible assets) can be carried out in practice. This is especially for non-marketable assets it is almost impossible to determine the central bank eligibility just on a theoretical basis. In practice, the central bank eligibility of these assets can only be determined by submitting the assets to the central bank.

10) Do you identify any overlaps with the existing reporting framework, which could be mitigated?

No further comments.

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